This record is a partial extract of the original cable. The full text of the original cable is not available.

C O N F I D E N T I A L SECTION 01 OF 03 TEGUCIGALPA 003149

SIPDIS

STATE FOR WHA, WHA/CEN, WHA/ESPC, DRL/IL, EB/EFD/OMA
STATE PASS AID FOR LAC/CEN
STATE PASS USTR, EXIM, OPIC
STATE PASS USED IDB, USED WB, USED IMF
TREASURY FOR JOHN JENKINS
LABOR FOR ILAB, ROBERT WHOLEY
PANAMA FOR CUSTOMS

E.O. 12958: DECL: 11/18/2012
TAGS: EFIN ECON EAID ETRD ELAB PGOV PREL HO
SUBJECT: HONDURAS: IMF PROGRAM NEGOTIATIONS DELAYED UNTIL SPRING 2003, PENDING GOH PROGRESS ON ECONOMIC REFORM

REF: TEGUCIGALPA 3023

Classified By: Economic Counselor Robin Matthewman; Reasons 1.5 (B) and (D).

Summary

¶1. (C) As expected, the IMF mission did not/not reach agreement with the GOH on draft terms of a three-year Poverty Reduction and Growth Facility Program (PRGF) during its November 4-15 visit to Honduras. In consultations with the IMF mission, the GOH developed a plan to improve the fiscal situation in the next few months. If all goes well, the team will return to Honduras in March or April to begin negotiations on a program. The delay of a program will put into jeopardy USD 240 million in debt relief, concessional loans and grants from some donors. It also puts into doubt the utility of a Consultative Group meeting currently planned for February 3-4. Two or three donors were highly critical of the IMF's approach. The IMF countered that the situation is unsustainable, unless donors want to continue to fund public sector salaries for Honduras year in and year out, and watch investment in poverty reduction programs continue to dwindle. Embassy recommends supporting the IMF on its push for real fiscal and economic reform in Honduras. End Summary.

Deteriorating Finances Dragging Down the Economy

¶2. (SBU) In a briefing for key donors (the G-15) on November 15, the head of the IMF mission, Mario Garza, said that the IMF is very worried about the current economic situation. The economy remains depressed, primarily because of the fiscal policy pursued in 2001 and 2002. If nothing is changed, the policy will continue to drag down the Honduran economy in 2003. Garza commended the improvements in revenue collection which the GOH has realized since passage of the tax reforms last spring; however, he noted that this improvement in tax administration will only arrest the alarming growth in the government's budget deficit. It will not put the GOH's finances on a sustainable path.

¶3. (SBU) Garza explained that the key figure the mission looked at is public sector savings (revenues minus current expenditures for the central government and other public sector entities), because it provides an indication of the amount of funds the government is able to generate for capital investment and discretionary social programs. Public sector savings declined from nine percent of GDP in 1999 to two percent in 2002 (a staggering decline of seven percentage points). With savings that weak, the government is unable to fund the needed social programs from its own resources; it has come to rely on foreign aid to do so. To highlight the enormous size of the foregone public sector savings each year, IMF PermRep Chungsuk Cha added that the planned HIPC debt relief (a one-time benefit for government finances for Highly Indebted Poor Countries) is ten percent of GDP. This figure pales in significance compared to losses every year of seven percent of GDP because of the GOH's current fiscal policy. In its press release, the IMF mission pointed out that Honduran exports and imports have contracted and that the lack of investment was an important contributor to the problem (as well as the decline in key commodity prices).

¶4. (SBU) Causes for the declining public sector savings can be found both on the expenditure and revenue sides. For example, current expenditures (primarily salaries) for the central government rose from 16.7 percent of GDP in 1999 to 18.6 percent in 2001 and 18.9 percent in 2002. At the same time, taxes declined from 17.5 percent of GDP in 1999 to 16.2 percent in 2001 and 15.6 percent in 2002. The public sector wage bill has risen from 8 percent of GDP in 1999 to 10 percent of GDP in 2001 and almost eleven percent in 2002. The average figure for the public sector wage bill in other

PRGF countries is five to six percent of GDP, according to the IMF.

Need for GOH to Develop Plan of Action

¶5. (SBU) Garza said that the government clearly sees the problem but is finding it difficult to quickly turn around the inherited problems. President Ricardo Maduro announced his intentions (on November 13) to push for a Fiscal Responsibility Pact with all sectors of society. The GOH intends to show the public the gap between revenues and needed expenditures and to engender enough public understanding to undertake the needed structural changes. The government will be working in the next few months on: 1) an assessment of tax policy; 2) a study of current expenditures to identify priority areas; 3) a review of the subsidy policy, to see where subsidies can be targeted to the sectors of society most in need; 4) a review of the financial situation of public enterprises, where savings have been declining over time; and 5) public sector administrative reform. The IMF mission also recommended that the GOH take a fresh look at the poverty reduction strategy paper (PRSP) first prepared in 2001 and identify the priority areas of public expenditures, given current macroeconomic constraints.

¶6. (C) The government believes it can identify necessary measures by March or April and would like to restart negotiations with the IMF at that time. This would mean that under the best case scenario, it will be June or July before Honduras once again has an IMF program. Until that time, many World Bank and IDB loans, grants from some donors, and debt relief will be held up. Garza estimated these add to USD 240 million in 2003. A large amount of this sum is Paris Club debt service. PermRep Cha indicated that the IMF will continue to be positive in its communications with the Paris Club about its continued work with the GOH. The IMF does not expect creditor countries in the Paris Club to push for resumption of debt service payments (only Germany indicated that it has been receiving demarches from its capital pushing the GOH to pay its Paris Club debt). On the margins of the meeting, the World Bank rep - just back from consultations in Washington - noted that while existing projects will continue (which includes its Reengineering Government project), new lending will be limited to what it considers its Low Case scenario.

Is the IMF Being Fair to Maduro?

¶7. (C) Garza dodged questions from the G-15 and the press on reasons the Fund gave a favorable review of the GOH's financial performance in September 2001, despite the existence of the same problems at that time. The German Ambassador, the Italian Ambassador, the Swedish counselor, and the UNDP rep all criticized the Fund's stance as unfair to the Maduro administration. They noted that the bulk of the growth in the current government expenditures (especially the wage bill) occurred during the Flores government, and the IMF did not declare the GOH off its program at that time. They argued that the IMF's position basically punishes the wrong people and that the economic difficulties the government will soon face because of its lack of an IMF program will result in destabilization of this reformist government. Other donors emphasized that the lack of an IMF program puts into doubt the utility of a Consultative Group meeting currently planned for February 3-4.

¶8. (C) In turn, the IMF reps urged the G-15 Ambassadors to encourage the GOH to seize the moment and make the necessary structural reforms. The IMF reps noted that the situation is not sustainable except in the unlikely circumstance that donors are willing to finance the government's fiscal deficit indefinitely (in addition to needed poverty reduction programs). They stated that they saw genuine commitment on behalf of the GOH to make these changes in the context of a Fiscal Responsibility Pact, and GOH needs the support of the donors to get it done. This window of opportunity would not last very long and may not come again, explained the IMF officials. In response to a question on the IMF's recommendations on tax policy, Garza noted that the discussions with the GOH centered on elimination of sales and income tax exemptions and not on increases in tax rates.

¶9. (U) In statements to the press, the IMF mission noted that actions by the National Banking and Insurance Commission (CNBS) had been satisfactory and that the Central Bank's policy of gradual depreciation of the lempiras is appropriate. They also mentioned that foreign reserves (four and a half months of imports) are adequate.

Comment

¶10. (C) The IMF's approval of the GOH's macroeconomic performance last year was based on projections on spending and tax collection that proved fallacious. At the end of the Flores administration traditional election year overspending was only delayed rather than avoided. To make the 2002 budget numbers work, then Finance Minister Gabriela Nunez apparently assumed an impractical 20 percent increase in tax revenues at the same time the Congress was enacting (and Flores was signing) a series of new tax exemptions and unfounded spending initiatives.

¶11. (C) Past inaction on macroeconomic and structural reforms has resulted in a stagnant economy and an unsustainable central government fiscal deficit. Post believes that the GOH macroeconomic team is committed to working toward the necessary changes in fiscal policy. However, all of these reforms will require political will on the part of a government that has a very slim coalition majority in Congress. High level officials in the Maduro government have continually asked the USG and other donors to push the IMF for flexibility and to understand what it views as political realities.

¶12. (C) Except in the area of improved tax administration, Post is not sanguine about the GOH's commitment and ability to push through long-lasting and structural economic reforms. Many of the measures that the GOH is only now trying to analyze - such as consolidation of ministries, improvement of the finances of the public enterprises and the reorientation of resources in the education ministry to teaching and away from administrative resources - could have been undertaken during the past ten months but were not. By the time this government is done with its study and analysis, its finances will only be that much further in the hole. While the Maduro government's rhetoric is strongly reformist, its actual performance to date indicates that it is unwilling to act and follow through on unpopular, but necessary, policy prescriptions. Embassy recommends supporting the IMF on its push for real fiscal and economic reform in Honduras. End Comment.

PALMER